

A *udit*

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DEFENSE ENTERPRISE FUND

Report No. D-2000-176

August 15, 2000

Office of the Inspector General
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Acronyms

CTR	Cooperative Threat Reduction
DEF	Defense Enterprise Fund
FSU	Former Soviet Union
WMD	Weapons of Mass Destruction



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2885

August 15, 2000

MEMORANDUM FOR DIRECTOR, DEFENSE THREAT REDUCTION AGENCY

SUBJECT: Audit Report on the Defense Enterprise Fund (Report No. D-2000-176)

We are providing this final report for your information and use. We performed the audit in accordance with Public Law 102-511, "Freedom for Russia and Emerging Eurasian Democracies and Open Markets Support Act of 1992," section 102(d), "Accountability for Funds," October 24, 1992. We considered management comments on a draft of this report when preparing the final report.

Management comments on the draft of this report conformed to the requirements of DoD Directive 7650.3 and left no unresolved issues. No additional comments are required.

We appreciate the courtesies extended to the audit staff. For additional information on this report, please contact Ms. Evelyn R. Klemstine at (703) 604-9172 (DSN 664-9172) (eklemstine@dodig.osd.mil) or Ms. Cheryl L. Snyder at (703) 604-9617 (DSN 664-9617) (csnyder@dodig.osd.mil). See Appendix C for the report distribution. The audit team members are listed inside the back cover.

A handwritten signature in black ink, reading "Robert J. Lieberman", is positioned above the typed name.

Robert J. Lieberman
Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. D-2000-176
(Project No. D2000LG-0031)

August 15, 2000

Defense Enterprise Fund

Executive Summary

Introduction. This audit was performed in accordance with Public Law 102-511, "Freedom for Russia and Emerging Eurasian Democracies and Open Markets Support Act of 1992," section 102(d), "Accountability for Funds," October 24, 1992. This is one in a series of reports being issued by the Inspector General, DoD, on the policies and procedures for executing the Cooperative Threat Reduction Program. The Cooperative Threat Reduction Program was initiated in FY 1992 to reduce the threat posed by weapons of mass destruction remaining in the territory of the former Soviet Union. In June 1994, DoD established, through a grant agreement, the Defense Enterprise Fund to assist Belarus, Kazakhstan, Russia, and Ukraine in the privatization of defense industries and conversion of military technologies and capabilities for civilian use. The Departments of Defense and State provided funding of \$66.7 million. Currently, the value of the fund's assets has declined to \$31.3 million.

Objectives. The overall audit objective was to review the policies and procedures related to the execution of the Cooperative Threat Reduction Program. The specific objective for this segment of the audit was to assess Cooperative Threat Reduction Program Office oversight and planning for the Defense Enterprise Fund. A subsequent report will discuss whether funds obligated under the Cooperative Threat Reduction Program were used in accordance with agreements made between the United States and the governments of Belarus, Kazakhstan, Russia, and Ukraine. A subsequent report will address the adequacy of the management control program.

Results. The Cooperative Threat Reduction Program Office needed to improve oversight and planning for the Defense Enterprise Fund. As a result, the Cooperative Threat Reduction Program Office could not effectively evaluate the status of the Defense Enterprise Fund or plan for the expiration of the grant agreement. In addition, the fund manager was not able to achieve the revenue and investment objectives in the Defense Enterprise Fund long-range plan for self-sufficiency.

Summary of Recommendations. We recommend that the Director, Cooperative Threat Reduction Program Office, ensure the use of a standard review methodology and document the results of Defense Enterprise Fund semi-annual progress reviews and visits made to offices of the fund manager and investment sites; establish measurable performance goals to evaluate the success of the Defense Enterprise Fund; update the Defense Enterprise Fund long-range plan for self-sufficiency to reflect the current status of the fund and economic condition of the former Soviet Union; and initiate efforts to develop an exit strategy for liquidating or selling the Defense Enterprise Fund.

Management Comments. The Deputy Director, Defense Threat Reduction Agency, concurred with the report's recommendations and has initiated corrective actions. A discussion of management comments is in the Finding section of the report and the complete text is in the Management Comments section.

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Background

Public Law 102-511, “Freedom for Russia and Emerging Eurasian Democracies and Open Markets Support Act of 1992,” section 102(d), “Accountability for Funds,” October 24, 1992, requires that any agency managing and implementing an assistance program for the countries of the former Soviet Union (FSU) shall be accountable for any funds made available to it for such a program.

Cooperative Threat Reduction Program. The Cooperative Threat Reduction (CTR) Program was initiated in FY 1992 to reduce the threat posed by weapons of mass destruction (WMD) remaining in the territory of the FSU. The Cooperative Threat Reduction Act of 1993, section 1204, 22 U.S.C. 5953 (1994), authorizes DoD to establish a private fund devoted to defense conversion.¹ The Defense Nuclear Agency² established the fund, and it was designated the Defense Enterprise Fund (DEF). The DEF is a not-for-profit corporation³ subject to DoD oversight by the CTR Program Office, which is a part of the Defense Threat Reduction Agency. The DEF provides financial support for commercial initiatives that facilitate the demilitarization of defense industries and conversion of military technologies and capabilities to civilian activities in eligible countries of the FSU. FSU countries eligible for assistance include Belarus,⁴ Kazakhstan, Russia, and Ukraine.

Defense Enterprise Fund. DoD provided funds to the DEF through Grant No. DNA001-94-J-0004, “Defense Enterprise Fund,” June 21, 1994 (the grant agreement). As of April 2000, DoD had provided \$51.7 million,⁵ and the Department of State provided \$15 million in FY 1997 under the Freedom Support Act.⁶ Upon expiration of the grant agreement in FY 2004, the fund will either become self-sufficient or be dissolved. In the event of dissolution, net proceeds will either return to the U.S. Government or be distributed to non-profit entities established to provide assistance in the FSU. The DEF invests U.S. Government funds in ventures that include at least one

¹Defense conversion is the transition of personnel or facilities that were formerly involved in research, development, production, or operation and support of the defense sector to peaceful, civilian activities.

²The Defense Nuclear Agency was renamed the Defense Special Weapons Agency, which was subsequently consolidated into the Defense Threat Reduction Agency, effective September 30, 1998.

³The DEF was legally incorporated in Delaware in March 1994. However, the grant agreement requires that the fund remain subject to U.S. Government oversight.

⁴The DEF has not invested in Belarus since FY 1997 because of human rights violations.

⁵DoD allocated funds for the DEF through the June 1994 grant agreement and a series of amendments from May 1995 through February 1997.

⁶To assist FSU countries in transitioning to peaceful endeavors, the Freedom Support Act authorizes the Department of State to design an assistance and economic cooperation strategy with FSU countries. In FY 1997, funding for the DEF shifted to the Department of State under the Freedom Support Act. The Department of State agreed that DoD would maintain DEF oversight responsibilities.

western⁷ business partner and an FSU business partner formerly engaged in the production of, or support for, WMD or other defense-related endeavors. The DEF makes loans and equity investments. See Appendix B for a discussion of current DEF investments and defense conversion achievements.

Fund Manager. At the inception of the fund in June 1994, the DEF did not employ a private fund manager. In February 1998, the DEF contracted with a private company to manage the fund. That company remained the fund manager until October 1999, when the DEF contracted with a New York-based investment manager to manage the fund through FY 2004 when the grant agreement expires. The DEF hired the current fund manager for its expertise in the Russian investment arena. As the fund manager, the company assumed responsibility for selecting appropriate investment proposals, identifying compatible investment partners, and providing management expertise. The company participates in all aspects of DEF investment management, to include:

- monitoring the status of DEF investments;
- consulting with the management staff of companies in which the DEF has invested and providing advice on financial and operational management strategies;
- planning and negotiating to maximize the value of DEF investments;
- analyzing, identifying, performing due diligence, and structuring and negotiating new DEF investments in the region or, making additional investments in companies in which the DEF has invested; and
- working with the DEF to attract private capital for investment in the region, to the extent that economic conditions in the region permit.

In addition, the company is responsible for planning for DEF self-sufficiency upon expiration of the grant agreement in FY 2004 or developing an exit strategy for liquidating DEF investments and dissolving the fund. The intent of the grant agreement was for the DEF to become a private, self-sufficient fund by attracting private capital. Essentially, either the fund would become financially independent and generate revenue that could be used to make new investments or it would be dissolved.

Economic Conditions in Russia. Early in 1998 when the Russian government significantly increased interest rates to support the value of the ruble⁸ and to attract and preserve foreign capital inflows to finance the budget deficit, Russia felt the impact of economic crisis. The high interest rates created a liquidity crisis that squeezed working capital financing throughout the Russian economy. The monetary policy collapsed in August 1998 when the Russian government implemented a 90-day moratorium on bank and company hard currency debt repayments, began negotiations to restructure government debt, and devalued

⁷The grant agreement requires that DEF investments include at least one business partner from outside the FSU; the partner is typically a U.S. firm.

⁸The ruble is the Russian currency.

the ruble. The economy experienced bank failures, a breakdown in commercial processes, sharp reductions in business activities, and scarcity of investment and working capital. All DEF investments in Russia were effected by the dramatic decline in the Russian economy and financial markets. As of March 2000, the gross investment value of the DEF portfolio was estimated to be only \$31.3 million.

Objectives

The overall audit objective was to review the policies and procedures related to the execution of the CTR Program. The specific objective for this segment of the audit was to assess CTR Program Office oversight and planning for the DEF. Subsequent audits will determine whether funds obligated under the CTR Program were used in accordance with agreements made between the United States and the governments of Belarus, Kazakhstan, Russia, and Ukraine. See Appendix A for a discussion of the audit scope, methodology, and prior coverage.

Evaluation of the Defense Enterprise Fund

The CTR Program Office needed to improve oversight and planning for the DEF. This occurred because the CTR Program Office did not:

- ensure the usefulness of semi-annual progress reviews and visits made to offices of the fund manager and investment sites by using consistent review approaches and documenting review results;
- develop measurable performance goals to evaluate the success of DEF investments; and
- update the DEF long-range plan for self-sufficiency to reflect current economic conditions in the FSU and initiate efforts to develop an exit strategy.

As a result, the CTR Program Office could not effectively evaluate the status of the DEF or plan for the expiration of the grant agreement. In addition, the fund manager was not able to achieve the revenue and investment objectives in the DEF long-range plan for self-sufficiency.

Criteria

The Grant Agreement. The grant agreement authorizes the DEF to provide loans and make equity investments in defense conversion projects that involve at least one business partner from outside the FSU and enterprises in FSU countries previously involved in the production of, or support for, WMD or other defense-related endeavors. The DoD, along with several U.S. Government agencies, developed a list of WMD-related firms that were candidates for defense conversion for each of the eligible FSU countries. The fund manager is required to select firms from one of the lists of WMD-related enterprises or notify the CTR Program Office if a firm in which it seeks to invest is not on one of the lists. The DEF may also make investments in facilities and personnel currently or formerly associated with other elements of the FSU defense sector converting to civilian activities. Other elements include command, control, and communications equipment; nuclear-equipped aircraft and guided missiles; and strategic defense systems such as anti-ballistic missiles and systems to counter strategic bombers.

Expiration of the Grant Agreement. When the grant agreement expires on June 20, 2004, the grant states net proceeds will either return to the U.S. Government or be distributed to the non-profit entities established to provide assistance in the FSU. In addition, the intent of the grant agreement was that the DEF would become a private, self-sufficient fund. The grant permits the sale of the fund as an entity. However, if the sale of the fund in its entirety is

not possible, the CTR Program Office must ensure that DEF investments are liquidated and that the funds are remitted to the U.S. Government or distributed to non-profit entities established to provide assistance in the FSU. The grant agreement also states that DoD must notify the fund manager at least 1 year in advance of the termination commencement date. Once the termination commencement date arrives, the fund manager cannot make any new commitments or investments and DEF affairs are to be concluded and assets sold.

Performance Measures. The Chief Financial Officers Act of 1990, November 15, 1990, as amended, requires Federal organizations to systematically measure performance. As a result of that requirement, the Federal Accounting Standards Advisory Board issued the Statement of Federal Financial Accounting Standard No. 4 (Financial Accounting Standard No. 4), “Managerial Cost Accounting Concepts and Standards for the Federal Government,” July 31, 1995, which contains guidance aimed at providing reliable and timely information on the full cost of Federal programs and their activities and outputs. Financial Accounting Standard No. 4 requires the development of performance measures and goals to which the measures can be compared as a means of reporting the efficiency, effectiveness, and results of a program.

Monitoring DEF Performance

The CTR Program Office needed to improve oversight and planning for the DEF.

Semi-Annual Progress Reviews. The CTR Program Office participated in semi-annual progress reviews with the fund manager. However, from FY 1997 through FY 2000, CTR Program officials maintained notes from only one review. In addition, CTR Program officials did not document answers to any of the questions they prepared to ask the fund manager during the reviews. The grant agreement requires that the CTR Program Office hold semi-annual progress reviews to exchange information with the fund manager about the overall financial health and performance of the fund, compliance with the terms of the grant agreement, and resolution of problems. The briefing charts provided by the fund manager indicated reviews covered DEF operating highlights, potential for self-sufficiency, investment performance against benchmarks, schedules for CTR Program Office visits, and project status. The CTR Program officials stated that the information collected during the semi-annual progress reviews formed a basis for determining whether the goals in the grant agreement were met. However, there was minimal evidence that CTR Program officials had evaluated accomplishments of the fund or documented lessons learned.

Office and Site Visits. CTR Program officials visited the offices of the fund manager and investment sites. However, the visits did not provide sufficient information to determine whether the DEF was meeting the goals set forth in the

grant agreement. Although the CTR Program Office had established a checklist of items to be reviewed during site visits, Program officials maintained only three undated, but otherwise completed, checklists for the nine site visits held during FY 1997 through FY 1999. Site visit checklist items included the previous activity of the FSU partner, the new commercial endeavor of the investment, approximate size of facilities converted, approximate number of former defense workers converted, and the DEF investment affect on conversion activities. In addition, CTR Program officials did not document the results of meetings held with the fund manager during office visits. The grant agreement requires CTR Program officials perform office visits and conduct approximately three site visits to DEF investments per year. During office visits, the fund manager and CTR Program officials discussed the overall status of the fund and the progress of specific investments. During site visits, CTR Program officials stated they visited the facilities of investments in the FSU and had an opportunity to speak with personnel who work for enterprises in which the DEF had invested. In addition, we observed that CTR Program officials toured facilities and watched employees who formerly produced WMD now working to create new commercial items in facilities that once supported the defense sector of the FSU. However, without adequate documentation of discussions and results from office visits and observations from site visits, the CTR Program Office did not have sufficient documentation to show whether and how they had evaluated the accomplishments of the fund.

Without adequate documentation of DEF matters, CTR Program officials may not be able to ensure continuity of operations from one CTR Program official to the next. Since FY 1997, two officials had handled the majority of DEF matters, to include participating in semi-annual progress reviews and office and site visits. Participating in those reviews and visits were subjective methods that the CTR Program Office used to monitor the performance of the DEF. However, without adequate documentation of discussions and results from the semi-annual progress reviews and office and site visits, the CTR Program Office may not have sufficient information to determine whether the DEF was meeting the goals set forth in the grant agreement. In addition, the CTR Program Office may not have sufficient information to determine the most appropriate approach for developing an exit strategy and disposing of the fund.

Evaluating DEF Performance

The CTR Program Office needed to improve oversight and planning for the DEF. This occurred because the CTR Program Office did not develop measurable performance goals to evaluate the success of DEF investments.

Meeting Goals in the Grant Agreement. The CTR Program Office did not have sufficient information to determine whether the DEF was achieving the goals set forth in the grant agreement. The United States provided \$66.7 million to the DEF for investment in FSU companies that had been

associated with the manufacture of WMD. According to the grant agreement, the success of the DEF would be determined by the extent to which the fund is able to meet or contribute to the following goals:

- successful demilitarization of an FSU defense industry and conversion of its military technologies and capabilities into civilian activities;
- successful restructuring, or strengthening, of a number of privatized FSU firms derived from industries and capabilities of the military-industrial complex of the FSU;
- development of a number of key joint business initiatives between the U.S. companies and FSU private companies; and
- generation of projects that will leverage U.S. private-sector capital.

DEF Benchmarks. CTR Program officials developed performance measures to evaluate the success of the fund; however, they did not establish performance goals against which DEF achievements could be compared. Financial Accounting Standard No. 4 requires development of performance measures as a means for reporting the efficiency, effectiveness, and results of a program. In FY 1997, the CTR Program Office and the fund manager collaborated to develop performance measures for the fund. However, those performance measures did not include quantifiable performance goals but rather were general categories for which each investment should contribute and the CTR Program Office was responsible for monitoring. In addition, CTR Program officials did not request that the fund manager verify the data reported during semi-annual progress reviews. The categories included square meters converted, former defense workers converted, percentage of the fund that was invested, leveraging of U.S. private funds, and the DEF net worth.

Square Meters Converted. The fund manager reported during the semi-annual progress reviews the estimated floor space converted from former manufacture of WMD to private enterprise as a result of DEF investments. As of March 2000, the fund manager estimated that 36,405 square meters were converted as a result of current DEF investments. However, CTR Program officials had not established a measurable performance goal against which the estimate could be compared. In addition, the CTR Program Office did not request that the fund manager verify the estimate of square meters converted, although that estimate had not changed since March 1998. Further, the fund manager did not report on whether defense conversions that were achieved as a result of DEF investments were in fact sustained. For example, in March 2000 one of the investments was reported to have converted 10,050 square meters of floor space for civilian use. However, the fund manager stated that the company suspended production activities in FY 1999. The fund manager was confident that the company would resume operations; however, as of March 2000, the company had not resumed production activities.

Former Defense Workers Converted. The fund manager reported during the semi-annual progress reviews an estimate of former WMD workers now employed as a result of DEF investments. As of March 2000, the fund manager estimated that 2,030 workers were converted as a result of current DEF investments. However, CTR Program officials had not established a measurable performance goal against which the estimate could be compared. In addition, the CTR Program Office did not request that the fund manager verify the estimate of defense workers converted, although that estimate had not changed since March 1998. Further, the fund manager did not report on whether defense conversions that were achieved as a result of DEF investments were in fact sustained. For example, in March 2000 one of the investments was reported to have employed 42 former WMD workers. However, the fund manager stated that the company suspended production activities in FY 1999 and only 1 worker was employed. The fund manager was confident that the company would resume operations and employ more people; however, as of March 2000, the company had not resumed production activities or employed more people.

Percentage of Fund Invested. The fund manager reported that the DEF was fully invested in the current portfolio. The DEF had invested \$38.3 million of the \$66.7 million provided by the U.S. Government in the current portfolio and had used \$32.6 million for expenses incurred since inception of the fund in June 1994.⁹ Though CTR Program officials and the fund manager discussed during the semi-annual progress reviews the high expense rate the DEF incurred, the CTR Program Office did not establish an objective, quantifiable, and measurable performance measure that would assist in determining whether the expense rate was too high.

Leveraging U.S. Private Funds. For the investments that had achieved defense conversions as of March 2000, the fund manager estimated approximately \$737 million in private capital would be required to complete the projects. However, CTR Program officials had not established a measurable performance goal against which the ratio of U.S. Government funds to private funds could be compared.

DEF Net Worth. According to the benchmark categories, the actual end-of-year DEF net worth should be compared with other similar funds to gauge success. However, the fund manager did not provide figures to the CTR Program Office on the end-of-year net worth of similar funds so CTR Program officials could compare the data and effectively evaluate the DEF net worth. In addition, CTR Program officials had not established a measurable performance goal against which the DEF net worth could be compared.

The CTR Program Office could not effectively evaluate the performance of the DEF because the Program Office did not establish performance goals against which actual defense conversion achievements and performance of the fund could be compared. In addition, the CTR Program officials had not requested that the fund manager verify estimates provided during semi-annual progress

⁹The \$4.2 million difference between the \$66.7 million provided and the \$70.9 million invested and used for expenses was attributable to interest and profits and losses on investments.

reviews and had not established a performance measure to address the cost of operating the fund. The CTR Program Office could not effectively monitor the status of individual investments or the overall status of the DEF without properly evaluating the performance of the fund against measurable performance goals.

Long-Range Planning for the DEF

The CTR Program Office needed to improve oversight and planning for the DEF. This occurred because the CTR Program Office did not update the DEF long-range plan for self-sufficiency to reflect current economic conditions in the FSU and did not initiate efforts to develop an exit strategy.

DEF Long-Range Plan for Self-Sufficiency. The CTR Program Office did not ensure the fund manager had updated the DEF long-range plan for self-sufficiency to reflect current economic conditions in the FSU. A May 1995 amendment to the grant agreement states that the DEF must produce a long-range plan to address how the fund would seek to become self-sufficient before expiration of the grant agreement in FY 2004. The fund manager prepared the original DEF long-range plan for self-sufficiency in FY 1997. The DEF is required to update the plan annually, however, the fund manager did not provide an updated plan. Although CTR Program officials stated they used information gathered during the semi-annual progress reviews to update the DEF long-range plan for self-sufficiency, the CTR Program Office could not provide an updated plan.

Exit Strategy. The CTR Program Office did not initiate efforts to develop an exit strategy. The disposition of the fund will depend on the status of each investment in the fund. However, as of April 2000, the CTR Program Office had not determined whether the fund would be sold in its entirety or whether each investment would be sold separately. The grant agreement requires that the CTR Program Office notify the DEF at least 1 year in advance of the termination commencement date. By the termination commencement date, the fund manager is required to provide a plan for the disposition of the fund to the CTR Program Office for approval. However, as of April 2000, neither the CTR Program Office nor the fund manager had begun to develop a plan. According to the fund manager, although the grant does not expire until FY 2004, investments will have to be positioned for sale. Therefore, to maximize the funds to be returned to the U.S. Government or otherwise distributed, the CTR Program Office should initiate efforts to plan for the disposition of the fund.

DEF Success and Sustainability

The CTR Program Office could not effectively evaluate the status of the DEF or plan for expiration of the grant agreement. In addition, the \$66.7 million that the U.S. Government invested in the DEF could be diminished beyond its current estimated \$31.3 million value. Also, the fund manager was not able to achieve the revenue and investment objectives in the DEF long-range plan for self-sufficiency.

Investment Problems. The U.S. Government investment could decline further in value if DEF management is not more aggressive. For example, the CTR Program Office has not taken action to resolve a problem with one of the investments that accounts for nearly \$6 million, or 19.2 percent, of the gross estimated investment value of the fund. Since FY 1997, the DEF has reported to the CTR Program Office during semi-annual progress reviews difficulties with investments. However, it was not until our review in March 2000 that the CTR Program Office took an active interest in the problems with that investment. The company with which the fund has had difficulties first received DEF funds in 1996 to assemble and distribute personal computer products. The company had previously been involved in the production of military electronics. In a January 1998 report on the company, requested by the fund manager, Ernst & Young stated there were difficulties obtaining detailed records to support the financial statements of the company and a significant part of the operations were not being reported. In addition, the report stated that the financial statements did not include all transactions or balances as appropriate for accounts receivable, cash, cost of sales, fixed assets, inventories, salaries, and sales. Specifically, the report pointed out that the company:

- estimated cash balances and used unofficial and unrecorded cash transactions;
- recorded unsubstantiated purchases in financial statements to claim additional value-added tax reimbursement;
- had not included all fixed assets or salaries in the financial statements;
- could not provide a list of accounts receivable, a detailed fixed asset listing, or documentation of inventory verification to support the financial statements prepared for the DEF and had not made adjustments to the general ledger to reconcile inventory differences; and
- recorded sales on a cash basis and adjusted accounts receivable in such a manner that the financial statements may have incorrectly included both opening and closing accounts receivable balances.

Though the DEF informed the CTR Program Office of the Ernst & Young report during a March 1998 semi-annual progress review, CTR Program officials did not obtain a copy of the report at that time and did not offer

guidance on the disposition of the investment. Through March 2000, the fund manager continued reporting the problems with the DEF investment to CTR Program officials during the semi-annual progress reviews. However, as of April 2000, the CTR Program Office had not taken action regarding the situation. The U.S. Government investment in the company was nearly \$6 million. As of April 2000, the fund manager estimated that the investment in this company was worth only \$1 million.

Achieving Objectives of the DEF Long Range Plan for Self-Sufficiency. The fund manager was not able to achieve the revenue and investment objectives of the DEF long-range plan for self-sufficiency. The objectives of the DEF long-range plan for self-sufficiency were to generate adequate revenues to support DEF operating costs while allowing the DEF to expand its investment activities. The CTR Program Office did not ensure that the fund manager updated the DEF long-range plan for self-sufficiency to reflect the impact that the current economic conditions in the FSU have had on the fund.

Revenues and Expenses. The fund manager was not able to achieve the revenue objectives in the DEF long-range plan for self-sufficiency. According to the DEF long-range plan for self-sufficiency, investments were expected to produce \$100 million during FY 1997 through FY 2001 while at the same time provide for operating expenses. However, data provided at the semi-annual progress review in March 2000 indicated that the fund had only generated returns on investments of \$4.6 million, far less than planned, while incurring expenses of \$32.6 million. The fund manager did not meet the revenue objectives in the DEF long-range plan for self-sufficiency and did not update the plan to reflect more realistic revenue objectives based on the current economic conditions in the FSU.

Investments Activities. The fund manager was not able to achieve the investment objectives in the DEF long-range plan for self-sufficiency. According to the DEF long-range plan for self-sufficiency, investments would be valued at approximately \$170 million upon expiration of the grant agreement in FY 2004. However, as of March 2000, the fund manager estimated that the DEF portfolio had a gross investment value of only \$31.3 million, far less than the investment objective in the DEF long-range plan for self-sufficiency. The fund manager did not update the DEF long-range plan for self-sufficiency to reflect more realistic investment objectives based on the current economic conditions in the FSU.

The fund manager was unable to meet the objectives in the DEF long-range plan for self-sufficiency, and the CTR Program Office did not ensure the plan was updated to acknowledge that it was unlikely the original objectives would be achieved considering the current status of the fund and the time remaining until the grant agreement expires.

Conclusion

The grant agreement indicated that the success of the DEF would be gauged on the extent to which the DEF was able to demilitarize the FSU military-industrial complex, strengthen privatized firms derived from the FSU military-industrial complex, and attract U.S. private sector capital for joint ventures with FSU private companies. The CTR Program Office, through its semi-annual progress reviews and office and site visits, had not documented the progress the DEF had made in achieving those goals. In addition, the CTR Program Office did not develop performance goals that would have aided in evaluating the success of the DEF in achieving those goals or objectives in the DEF long-range plan for self-sufficiency. Without measurable performance goals, the results of the DEF could not be efficiently and effectively reported.

Recommendations and Management Comments

We recommend that the Director, Cooperative Threat Reduction Program Office:

- 1. Ensure the use of a standard review methodology and document the results of Defense Enterprise Fund semi-annual progress reviews and visits made to offices of the fund manager and investment sites.**
- 2. Establish measurable performance goals to evaluate the success of the Defense Enterprise Fund.**
- 3. Update the Defense Enterprise Fund long-range plan for self-sufficiency to reflect the current status of the fund and the economic condition of the former Soviet Union.**
- 4. Initiate efforts to develop an exit strategy for liquidating or selling the Defense Enterprise Fund.**

Management Comments. The Deputy Director, Defense Threat Reduction Agency, concurred with the report's recommendations, stating that DEF project managers will issue a report to management 10 days after a progress review or site visit; the Defense Threat Reduction Agency will work with industry to establish additional measurable goals and monitor DEF management's progress in meeting those goals by the end of 2000; DEF management will provide an updated long-range plan for self-sufficiency by November 1, 2000; and the Defense Threat Reduction Agency, with the involvement of DEF management, will develop an exit strategy.

Appendix A. Audit Process

Scope

We evaluated CTR Program Office oversight of the DEF. We interviewed CTR Program officials who were responsible for planning for the DEF. We reviewed the DEF grant agreement and amendments, corporation materials, semi-annual progress reviews, benchmarks, the DEF long-range plan for self-sufficiency, fund management agreement, and DEF reports. In addition, we visited the New York office of the fund manager to interview the President of the DEF and to review shareholder agreements and annual reports and audits for compliance with the grant agreement. Also, we visited the Moscow office of the fund manager and three DEF investments located in Moscow and Saint Petersburg, Russia, to observe events during CTR Program Office site visits. The documentation we reviewed covered the period from September 1989 through March 2000.

DoD-wide Corporate Level Goals. In response to the Government Performance and Results Act, the Secretary of Defense annually establishes DoD-wide corporate level goals, subordinate performance goals, and performance measures. This report pertains to the achievement of the following goal and subordinate performance goal.

FY 2000 DoD Corporate Level Goal 1: Shape the international environment and respond to the full spectrum of crises by providing appropriately sized, positioned, and mobile forces. **(00-DoD-1.1)**

FY 2000 Subordinate Performance Goal 1.1: Support U.S. regional security alliances through military-to-military contacts and the routine presence of ready forces overseas, maintained at force levels determined by the Quadrennial Defense Review. **(00-DoD-1.1)**

General Accounting Office High-Risk Area. The General Accounting Office has identified several high-risk areas in the DoD. This report provides coverage of the Defense Financial Management high-risk area.

Methodology

Audit Type, Dates, and Standards. We performed this program audit from January through May 2000 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. We did not use computer-processed data to perform this audit.

Contacts During the Audit. We visited or contacted individuals and organizations within DoD and within four private companies. Further details are available on request.

Management Control Program. We did not address the adequacy of the overall CTR Program Office management control program in this report. The adequacy of the overall CTR Program Office management control program will be addressed in a subsequent report.

Prior Coverage

During the last 5 years, the General Accounting Office issued one report related to the DEF.

General Accounting Office

General Accounting Office Report No. NSIAD-97-101 (OSD Case No. 1308), "Cooperative Threat Reduction: Status of Defense Conversion Efforts in the Former Soviet Union," April 11, 1997

Appendix B. Defense Enterprise Fund Investments

As of March 2000, the U.S. Government had provided \$66.7 million in grant funds to the DEF and the current DEF portfolio consisted of 12 investments. The fund manager estimated that, after write-offs, the current value of the 12 investments was \$31.3 million. Five of the 12 investments were active: 2 in Kazakhstan and 3 in Russia. The DEF has sold one investment and written off the interest in the other six investments. The table below summarizes the 12 investments, the defense conversion achievements of those investments as of March 2000, and the amount of grant funds in each investment.

DEF Investments				
Investment	Location	Workers Converted ²	Space Converted (square meters) ²	Grant Funds Invested ¹ (thousands)
Beryllium Component Technology	Russia	N/A ³	N/A	\$ 200
Impregnated Abrasive Instruments	Russia	N/A	N/A	200
KK Interconnect	Kazakhstan	27	3,600	3,050
Liform	Ukraine	42	10,050	800
Metallurgicheski Zavod Ametist	Russia	N/A	N/A	5,039
MPS – Telekom ⁴	Russia	1,240	7,900	9,565
Nursat	Kazakhstan	69	9,630	3,000
RAMEC	Russia	152	3,500	5,988
Rusnet Labs	Russia	200	1,725	5,000
Russian-American Ionized Energy Services	Russia	N/A	N/A	800
Russian Telecommunications Network	Russia	300	0	4,500
Sukhoi Naptha International	Russia	N/A	N/A	200
Subtotal		2,030	36,405	\$38,322
Write-offs				(6,985)
Total				\$31,337

¹The total of equity investments in and loans and letters of credit provided by the fund manager to investee companies.

²Estimates from business plan projections of head count and defense facilities being converted to commercial use.

³Not applicable.

⁴In March 2000, MPS Telekom was in the process of being sold; the fund manager expects to recover approximately \$6.0 million of the DEF investment.

The five active DEF investments as of March 2000 were KK Interconnect, Nursat, RAMEC, Rusnet Labs, and the Russian Telecommunications Network.

KK Interconnect. The DEF invested in KK Interconnect in September 1996. KK Interconnect was previously involved in nuclear weapons testing. As a result of the DEF investment, KK Interconnect became a manufacturer of

commercial printed circuit boards and products that use circuit boards. As of March 2000, the DEF had \$3.05 million in the investment and estimated that the investment had converted 27 former nuclear scientists and personnel and 3,600 square meters of former nuclear weapons testing sites and grounds to private enterprise.

Nursat. The DEF invested in Nursat in June 1996. Nursat was previously involved in satellite tracking. As a result of the DEF investment, Nursat became a commercial telecommunication service provider. As of March 2000, the DEF had \$3 million in the investment and estimated that the investment had converted 69 former defense workers and 9,630 square meters of a former satellite tracking facility to private enterprise.

RAMEC. The DEF invested in RAMEC in August 1996. RAMEC had previously produced military electronics. As a result of the DEF investment, RAMEC became an assembler and distributor of personal computer products. As of March 2000, the DEF had nearly \$6 million in the investment and estimated that the investment had converted 152 former defense workers and 3,500 square meters of former military production plant space to private enterprise.

Rusnet Labs. The DEF invested in Rusnet Labs in June 1997. The company was previously involved in maintaining strategic command and control networks. As a result of the DEF investment, Rusnet Labs became a telecommunication-engineering service provider. As of March 2000, the DEF had \$5 million in the investment and estimated that the investment had converted 200 former defense telecommunication engineers and 1,725 square meters of a former military communication facility to private enterprise.

Russian Telecommunications Network. The DEF invested in the Russian Telecommunications Network in December 1997. The Russian Telecommunications Network was previously involved in military communications. As a result of the DEF investment, the company became a commercial telephone service provider. As of March 2000, the DEF had \$4.5 million in the investment and estimated that the investment had converted 300 former defense engineers to private enterprise.

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Technology, and Logistics
 Director, Defense Logistics Studies Information Exchange
Under Secretary of Defense for Policy
 Assistant Secretary of Defense (Strategy and Threat Reduction)
 Deputy Assistant Secretary of Defense (Threat Reduction Policy)
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Other Defense Organizations

Director, Defense Threat Reduction Agency

Non-Defense Federal Organizations and Individuals

Office of Management and Budget
General Accounting Office
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Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

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Senate Subcommittee on Defense, Committee on Appropriations
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House Subcommittee on Defense, Committee on Appropriations
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House Committee on Government Reform
House Subcommittee on Government Management, Information, and Technology,
Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International
Relations, Committee on Government Reform
House Committee on International Relations
House Subcommittee on International Economic Policy and Trade, Committee on
International Relations

Defense Threat Reduction Agency Comments



Defense Threat Reduction Agency
45045 Aviation Drive
Dulles, VA 20166-7517

AUG 8 2000

MEMORANDUM FOR DEPARTMENT OF DEFENSE INSPECTOR GENERAL

SUBJECT: DTRA Comments on Proposed Audit Report on the Defense Enterprise Fund (Project No. D2000LG-0031) (Formerly Project No. 0LG-5105)

The Defense Threat Reduction Agency (DTRA) extends its appreciation to the audit staff for its work to improve the management and implementation of the US assistance program for the independent states of the former Soviet Union. As requested in your correspondence to us dated May 26, 2000, we offer the following comments in response to the draft audit report developed by your agency.

The audit report lists four recommendations for improving DTRA's management of the Defense Enterprise Fund (DEF). Your recommendations and our responses are as follows:

a. Ensure the use of a standard review methodology and document the results of DEF semi-annual progress reviews and visits made to the offices of the fund manager and investment sites.

DTRA concurs with this recommendation and acknowledges that its monitoring of the DEF needs improvement. DTRA will implement improved documentation of progress reviews and site visits commencing with the next DEF review. DTRA's DEF project manager will issue a report to the management of the DEF within 10 days of a progress review or site visit clearly documenting the visit. The report will include issues, action items, and recommendations.

b. Establish measurable performance goals to evaluate the success of the DEF.

DTRA concurs with this recommendation and acknowledges that its establishment of measurable performance goals needs improvement. Even though performance goals were established in the past, DTRA will work with industry to establish additional measurable goals. DTRA will then coordinate them with DEF management and seek their agreement. These additional goals will be implemented as appropriate by the end of calendar year 2000. DTRA will then monitor the DEF management's progress in meeting those goals for the duration of its DTRA grant.

c. Update the DEF long-range plan for self-sufficiency to reflect the current status of the fund and the economic condition of the former Soviet Union.

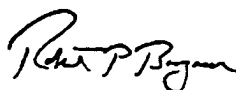
DTRA concurs with this recommendation and will direct the DEF, in conformance with the Grant Agreement, to provide an updated plan by 1 November 2000.

d. Initiate efforts to develop an exit strategy for liquidating or selling the DEF.

DTRA concurs with the recommendation and will develop an exit strategy in line with the principles expressed in Congressional testimony on other similar funds. Beginning with the discussion of the updated self-sufficiency plan referred to in recommendation 3 above, DTRA will involve DEF management in the effort to develop an exit strategy and will provide the DEF at least two years prior notification of its decisions to ensure the goals of the program are optimized.

Congressional testimony on the DEF and other similar funds created by Congress provides DTRA with insight for planning the final disposition of the DEF: "A guiding philosophical principle is that the Enterprise Funds should not return a profit to the U.S. Government from investments...In other words, our assistance program should not be a U.S. Government moneymaker. Any profits earned should stay in the country where they were made. Also, we need to recognize that not all of what Enterprise Funds do is profit-driven. Technical assistance and micro lending are some of the developmental activities which Funds engage in, knowing in advance that they are unlikely to recover their costs. This is because the goal of the Funds is private sector demonstration and development; not simply profit maximization." (Mr. James Holmes, Coordinator for Eastern Europe Assistance, Department of State, before the Committee on International Relations, House of Representatives, June 26, 1997.).

Please contact Mr. John Connell, DTRA/CTU, at (703)326-8547 or via e-mail at john.connell@dttra.mil for additional information.



Robert P. Bongiovi
Major General, USAF
Deputy Director

Audit Team Members

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